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The Corporate Income Tax*

Practically from the moment of its inception in 1909, the corporate income tax has been the subject of considerable controversy. Economists have clashed repeatedly over who really pays it: stockholders, owners of capital in general, consumers, or labor. Other discussions have revolved around the impact of the corporate income tax on business investment decisions and how such investments are financed. More recently, the introduction of the investment tax credit and other preferences, along with the recent liberalization of depreciation allowances, have sharply reduced the percentage of total Federal tax revenues contributed by corporate income tax receipts. It has also come to the attention of the media and others that because of these various provisions, corporate income is not measured or taxed uniformly, thus causing effective rates of taxation to vary widely among firms and industries.

Not surprisingly, a number of people have set out to "reform" the corporate income tax. This has brought together such disparate groups as consumer advocates, academic liberals—and the Reagan Administration. Because it is unclear who actually pays the corporate income tax, and because Washington is faced with a budget deficit of monumental proportions, it is easy to see why corporations are tempting targets for a tax increase. But before such a change is instituted, it is necessary to examine very carefully what it would mean for the economy with respect to capital formation, productivity growth, inflation, and living standards in general, both in the short run and in the long run, as well.

Taxing The Privilege

It is not hard to see why the taxation of corporate incomes has occurred over the years. A business enterprise enjoys special privileges and benefits when it operates in the corporate form. These include perpetual life, limited liability of shareholders, liquidity of ownership through marketability of corporate stock, growth through retained earnings, and possibilities of intercorporate affiliations. Since these privileges exist because of Federal legislation, a corporate income tax was seen as a means for the government to share in the gains resulting from a government sanctioned form of business organization. Some people also claim that if there were no corporate income tax, people could avoid the individual income tax by accumulating income in corporations.

Initially taxed at a rate of only one percent, corporate income came to be regarded more and more as a source of government revenue than as a tax on the benefits of incorporation as government spending increased. During World War I, the tax rate on corporate income was increased to 12 percent. In 1936 the proportional tax was replaced with a graduated tax with rates from eight percent to 15 percent. By World War II, the maximum tax rate had risen to 40 percent, while in the Korean War it reached 52 percent. Tax rates have declined since 1969, however, repeated modifications of the rules for computing taxable income and tax liabilities have reduced the effective corporate tax rate even more.

Considering the controversy over who actually pays the corporate income tax, it is nothing short of amazing that both the nominal and the effective corporate tax rate have come down. While most businessmen would view corporate taxes as another cost of doing business—a cost to be passed along in the form of higher prices—there seems to be quite a lively discussion among economists as to whether or not this is true.

Short- vs. Long-Run

From here, it would appear that the question of who bears the burden of the corporate income tax depends on the period of time involved. Examining the corporate income tax by distinguishing between short- and long-run

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time periods helps to narrow the differences somewhat. In the short run, the corporate income tax will either influence selling prices or not depending on the kind of markets in which businesses operate. Under conditions of the two extremes in competition—perfect competition or monopoly—business firms will seek to maximize net profits. The maximum occurs when the cost of producing an additional unit is exactly equal to the additional revenue obtained from the sale of that unit. A tax on economic profit makes no difference in this decision, since the tax applies to profits earned from the sale of all units—not profits from the last unit.

On the other hand, most of today's market structures are neither perfectly competitive nor monopolistic. Rather, they show considerable imperfection and mutual interdependence, or oligopoly. Under these circumstances, business firms tend to set their prices at the level that covers their full cost plus a margin for profits. In this instance, taxes are included in cost calculations. Alternatively, businesses might aim at an after-tax rate of return on invested capital. Thus, the imposition of a tax or an increase in the tax rate, by reducing the rate of return on invested capital, will have to be taken into account in making output and price decisions. In most instances, the incidence of the tax will be shifted forward to consumers in the form of higher prices.

In the long run, the corporate income tax appears to influence investment by reducing the rate of return on corporate equity. If business cannot shift the tax in the short run, after-tax rates of return are depressed and the incentive to undertake corporate investment is thereby reduced. These lead me to the next point, and that is the impact of the corporate tax on business investment.

In deciding whether to invest in a project, most managers begin by calculating the project's expected rate of return. This is then compared with management's objectives regarding the minimum rate of return required of these investment projects. Obviously, if the expected rate of return exceeds the required rate, the project will be undertaken. The expected rate of return on investment is derived from three factors: after-tax profits on the investment, the value of the depreciation deductions that can be taken over the life of the project, as well as its initial cost. Plainly, the greater the rate of after-tax profits, the greater will be the rate of return. By the same token, since depreciation is deducted from gross income in computing taxable income, the greater the value of the depreciation deductions, the greater the project's expected rate of return. And of course, the less a project costs, the higher will be its expected rate of return.

If tax rates are raised, they will reduce returns on investment by cutting after-tax profits. Similarly, stretched-out write-off periods and nonaccelerated depreciation methods decrease expected rates of return by decreasing the value of depreciation deductions.

The corporate income tax encourages investment in projects that use relatively more depreciable capital and relatively less labor and nondepreciable capital. It also encourages investment in short-term depreciable assets—particularly equipment—while discouraging investment in long-term depreciable assets, especially structures. In general, the corporate income tax probably reduces the amount of investment undertaken by all businesses because the double taxation of corporate income (once when earned by business and once when earned by shareholders in the form of dividends) leads to a reallocation of capital and labor that reduces the after-tax profitability of all capital and, therefore, reduces the flow of funds to business.

Use of Debt Encouraged

The corporate tax also encourages the use of debt as a means of raising money instead of equity. This is because interest expenses can be deducted from pretax corporate income, whereas dividends can not. Indeed, as debt is substituted for equity, corporate shareholders receive the tax saving that results from interest expenses lowering taxable income, thus corporate income taxes. Of course, financing investment by use of debt rather than equity affects the cost of capital against which investment projects' expected rates of return will be compared.

Because the uneven tax treatment of dividends versus interest makes it more expensive to raise capital by equity than by debt, some people believe that the more investment projects funded by debt, the lower the cost of capital and the greater the number of projects that will meet the minimum return on investment criterion. They have used this fact to argue that the corporate income tax has little effect on total investment. But it is not quite so simple. Financial experts discourage large amounts of debt financing by corporations. Too much use of debt compared with equity increases leverage and could lead to defaults on interest and principal payments, and bankruptcies in periods of recession and/or rising interest rates.

Turning to the impact on our balance of payments, when the international monetary system consisted of fixed exchange rates, it was contended that a lower corporate income tax, combined with a value-added tax that would be rebated on exports, would tend to discourage the

outflow of capital from the United States. The resulting greater availability of funds would lead to greater investments, improved productivity and an enhanced competitive position of U.S. industry, thus helping the balance of payments. However, in today's regime of floating exchange rates, changes in corporate taxes would have little effect on the competitiveness of goods manufactured by U.S. companies, or the United States' attractiveness as a place to invest. While lower taxes might attract capital to the U.S., this would raise the value of the dollar, thereby cutting our competitiveness in world markets.

In view of the importance of corporate profits on the one hand, and the distorting impact that the corporate income tax has on investments and methods of financing on the other, you would think that the Treasury's tax reform proposals would keep these pluses in mind while addressing the minuses. Although the Treasury does propose to reduce the corporate tax rate from a maximum of 46 percent to 33 percent, it also proposes to do away with the Accelerated Cost Recovery System and the investment tax credit. The net outcome would seem to be an increase in the cost of capital, a decrease in corporate liquidity and a decrease in capital investment. Over the ten years 1984–1994, there could well be a jump of over 30 percent in corporate tax revenues as a result of this change.

The Treasury's Motives

In making this decision to go after the goose that lays the golden egg, the Treasury must have concluded either that big budget deficits are here to stay, thus more room must be made for the government to finance them, or that the only way that these deficits can be brought down would be through revenue enhancements, as opposed to spending cuts, because the proposals for tax reform clearly aim in both directions.

For one thing, by substituting the Real Cost Recovery System for the Accelerated Cost Recovery System and by eliminating the investment tax credit, the Treasury will raise the cost of capital formation. Because of this increase in the cost of capital, business will have an increased incentive to substitute labor for capital. In turn, the fall in the capital-labor ratio will result in substantially less productivity growth for the American economy. Less productivity growth and higher rates of employment will cause the rate of inflation to go up. The higher rate of inflation will boost nominal GNP and both individual and corporate tax revenues, although there would be some offset from the indexing provisions at both the individual and corporate levels. There won't be that much of an offset, however, since the Treasury's proposal would raise roughly $165 billion more than the present law over the period 1984–1994, according to an analysis by the Wharton Econometric Model.

Since raising the cost of capital will depress corporate investment, it is likely that there will be less corporate borrowing. This alone will tend to make room for the government to raise money to finance its deficit. And if Washington does manage to increase its tax take thus cutting its borrowing needs, then lower interest rates could result. The immediate effect of lower interest rates would be to further help the government's budget position, although it might also make some marginal investment projects more viable.

One point should be noted before closing. The Federal tax burden on corporations is not as low as it seems. It may be true that the corporate income tax accounted for only nine percent of Federal tax receipts last year compared with 17 percent in 1970 and 29 percent in 1950. However, it should also be noted that corporate profits are a much smaller part of the economy today than they once were. Corporate income as a share of GNP in 1984 was only six percent compared with 14 percent in 1950. Little wonder that a tax on corporate income accounts for a smaller portion of total Federal revenues.

Looked at another way, corporations actually pay a very high percentage of their income to the Federal government—a much higher percentage than most individuals pay. According to the Commerce Department, corporations pay about 50 percent of their income to the Federal government. at least half of that due to the corporate income tax alone. By contrast, individuals pay an average of ten percent of their personal incomes in the form of income taxes.

In conclusion, it seems to me that corporate profits and the corporate income tax remain the favorite whipping boy of the politicians, reformers, and so on. Whether in the name of "equity" or simply as a hidden means of raising revenues, corporate profits seem likely to be subject to higher taxes. But before this occurs, we should keep in mind that this would slow economic growth, lessen productivity gains, increase the rate of inflation, and decrease our standard of living. It could also make business even more dependent on borrowed funds than it already is, thus more susceptible to changes in the economic and financial climate.

Whatever the government might accomplish in the short run, it would be at the expense of greater economic instability, longer-term. H

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